THE VOICE OF PRIVATE CAPITAL
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SFDR Known Unknowns

Non-paper

Background

Many of the disclosure obligations in the EU Sustainable Finance Disclosure Regulation 2019/2088 (SFDR) will apply from 10 March 2021. There are several areas of uncertainty and, with less than two months until 10 March, many member firms are struggling with the same "known unknowns".

The Regulation "lays down harmonised rules for financial market participants and financial advisers on transparency with regard to the integration of sustainability risks and the consideration of adverse sustainability impacts in their processes and the provision of sustainability-related information with respect to financial products." (SFDR, Article 1)

In light of the proximity to 10 March and the lack of recent commentary from the European Commission or European Supervisory Authorities (ESAs), Invest Europe convened a forum of GPs, LPs and advisers on 11 January to discuss whether it is possible to agree certain positions that member firms might take in response to SFDR. The meetings were held under Chatham House rules. The discussions and their conclusions are documented below.

This paper reflects the discussions held on 11, 18 and 26 January 2021. Some of the positions which are articulated below may need to change in response to further commentary, guidance or rules.

In sum, we interpret Article 6 (Transparency of the integration of sustainability risks) to address core ESG integration practices whereas Article 8 (Transparency of the promotion of environmental or social characteristics in pre-contractual disclosure) heightens the investment process for additional consideration beyond financial objectives. Article 9 (Transparency of sustainable investments in pre-contractual disclosures) is confined to products that have "sustainable investment" (as defined in the SFDR) as their objective.

The private equity and venture capital industry has made significant progress on developing ESG practices and Invest Europe's members believe that consideration of sustainability risks is a vital part of the assessment of any prospective portfolio company and plays a key role in the stewardship of that investment during the private equity or venture capital fund's holding period.

Article 6 will allow private equity funds to disclose on a range of approaches, from adoption of minimum standards to robust consideration of ESG factors in the investment decision making process and portfolio management.

Place du Champ de Mars 5
B-1050 Brussels, Belgium
T +32 2 715 00 20
F +32 2 725 07 04
www.investeurope.eu
info@investeurope.eu
European Transparency
Register: 60975211600-74

Questions and Answers

1. Article 8 scope

Issue

There has not been any meaningful commentary on the scope of Article 8 from the ESAs since last summer. The legal uncertainty is problematic: there is a short lead time to 10 March 2021. In some circumstances firms managing Article 8 products will need to make detailed reports to investors pursuant to the Taxonomy Regulation from 2022, and some may need to make a considerable investment in systems in order to gather data for that purpose.

In that context, there is set out below a suggested position which the industry could adopt. It is understood that this may be an interim position which might need to evolve. In particular, it might need to be adapted in light of any further Commission or ESA guidance.

If adopted, the suggested position would provide members with a framework for assessing whether their products will engage Article 8 in the absence of clear legal rules or guidance.

Importantly, the suggested interpretation would *not* prevent any member from taking the position that some or all of their products engage Article 8, if they wish to do so for strategic reasons. Neither would it prevent firms who conclude that their products do not engage Article 8 from voluntarily providing the same or similar levels of investor reporting as would be required in respect of an Article 8 product.

Suggested position

Article 8 will only be engaged if the product **promotes** environmental and/or social characteristics in a way that suggests that certain investments would not be made by the product even if those investments otherwise meet the fund's risk and return objectives. Therefore, in order for a product to meet the Article 8 threshold, the manager would apply two conditions before a prospective investment could be approved for investment by the fund: that the investment satisfies the fund's risk and return objectives (which in most cases will be at least market-level returns) and meets a pre-defined environmental or social standard. Such a standard could cover (i) investments that would be avoided for certain negative externalities and/or (ii) investments that have certain positive environmental and/or social characteristics. Such a two-pronged approach would help differentiate an Article 8 product from other funds, and help define its scope.

It would follow from reaching this position that, absent other active promotion of environmental or social characteristics, the following could form part of Article 6 disclosures but none would be sufficient to engage Article 8:

- Fund-level sustainability-related disclosures regarding investment processes if they are made only to comply with a legal obligation (e.g. a sustainability risk disclosure per Article 6 SFDR).

- Fund-level sustainability-related disclosures explicitly or implicitly related to the firm's obligations to maximise risk-adjusted investment returns and not constraining investment decisions by reference to environmental or social considerations (i.e. no dual conditionality).

- The sponsoring firm's subscription to certain sustainability frameworks or standards, in particular where those frameworks focus on management of financially material sustainability risks and explicitly recognise that fiduciary (i.e. risk and return related) obligations to investors are paramount (for example, the Principles for Responsible Investment[1]), or mandate reporting.

Furthermore, Article 8 should not be triggered merely because a product incorporates a norms-based or other exclusion screen (for example, a screen for tobacco or pornography). Similarly, a merely confirmatory response to an investor request / enquiry - i.e. where a sponsor confirms, when asked, that its product is not going to do [X] - should not push the product into Article 8 provided that [X] has not previously been identified as part of the product's strategy. This is particularly relevant in the context of side letter assurances which may be given on a 'for-avoidance-of-doubt' basis rather than as substantive commercial concessions.

2. Article 8 and legacy funds

Question: Participants discussed the relevance of Article 8 to funds which have closed prior to 10 March 2021 (**legacy funds**). This is a live issue because there is no express grandfathering relief in SFDR for legacy funds.

There are a range of potential approaches, from taking a pragmatic view that SFDR should not be "backward looking" and excluding legacy funds from scope entirely, to needing to comply with SFDR's disclosure requirements in full in respect of such funds, including Article 8 and potentially reporting under the Taxonomy Regulation, if relevant.

Position: *There was a consensus that Article 8 should not be applied retroactively to closed-end funds. SFDR is forward looking, applicable to products in market on or after 10 March 2021. Participants recognised that this approach involves accepting some legal risk, but considered this to be acceptable, particularly in light of the difficulty associated with collecting relevant information in respect of legacy products.*

[1] The Principles for Responsible Investment are explicitly subject to a firm's "fiduciary" duties. As stated in the signatory declaration: "In signing the Principles, we as investors publicly commit to adopt and implement them, *where consistent with our fiduciary responsibilities*."

3. Opting into PAIs whilst Level 2 is uncertain

Question: Many asset managers will have the flexibility to choose whether to opt in or out of the PAI (Principal Adverse Impacts) regime. Their decision will likely balance effort/resourcing with IR and/or strategic priorities. This decision is made more complicated by the delay to the Level 2 rules (the Regulatory Technical Standards currently under development by the ESAs), which means that a manager who opts in in 2021 may not know until very late in the day what the detail of opting in involves. Participants were asked to share whether they intended to opt in from day one: 10 March 2021, or opt out in the immediate term and keep this position under review.

Position: *The majority of GPs present were expecting to opt out on 10 March 2021, but will keep this decision under review in the short to medium term afterwards.*

4. Application to non-EU firms

Question: SFDR does not distinguish between EU and non-EU firms (it only refers to, for example, "Financial Market Participants"). Non-EU AIFMs marketing AIFs into Europe will therefore need to take a position regarding whether SFDR will apply at firm level, fund level or both.

Position: *Although this discussion was not relevant to all participants, those who spoke agreed with the general proposition that only fund level obligations apply in the context of a non-EU manager marketing a fund into the EU.*

5. When are first reports due?

Question: The SFDR periodic reporting obligations for products engaging Articles 8 or 9 apply *from* 1 January 2022. However, what this means in practice is unclear. There are several potential readings:

(a) One reading is that the first periodic report issued after 1 January 2022 needs to include all of the required SFDR disclosures. But there are still uncertainties even if a firm takes this view. For example, consider a product with a 31 December year-end. This reading could either mean that:

i. firms need to start collecting data from 1 January 2021, before SFDR is in force, in order to make a full report on the 2021 cycle from 1 January 2022; or

ii. firms need to start collecting data from 10 March 2021. This would mean that the SFDR disclosure in the first report post-implementation would be a partial disclosure, based on a partial year (10 March 2021 to 31 December 2021).

(b) The second reading is that the reporting *reference* period begins from 1 January 2022. It is at this point that firms will need to start capturing the data for the report, i.e. to report in 2023 regarding the 2022 reporting cycle.

Position: *The participants agreed that they would be prepared to follow the second reading in (b) unless further guidance is published to the contrary.*

6. Position of sub-threshold AIFMs

Question: SFDR does not distinguish between sub-threshold and fully-authorised AIFMs; each seems to be a financial market participant. The application of SFDR - at firm level, product level or neither - is very unclear.

- *Firm level*: one view is that a sub-threshold AIFM is an AIFM as defined in AIFMD and should therefore be subject to SFDR's firm level obligations, just as full-scope EU AIFMs will be.

  An alternative view is that firms should "read in" the AIFMD exemption for sub-threshold firms, which would logically exempt them from SFDR's firm level obligations altogether.

- *Product level*: one view is that as sub-threshold AIFMs are not entitled to market funds pursuant to a pan-EEA passport, they should not be subject to SFDR product-level obligations either.

Amongst these often contradictory views is a suggestion that pan-EEA interpretations do not work for sub-threshold AIFMs. The regulation of such firms is driven by the requirements of their home state, so perhaps it makes most sense to let their home state determine the application of SFDR to them?

Position: *The question of how SFDR applies to a sub-threshold AIFM should be a question determined by the law of the (home) Member State of that AIFM.*

7. Public disclosures

Article 10 of the SFDR requires certain financial market participants to make website disclosures in relation to Article 8 and Article 9 products. We think it is important for the Commission to confirm that this obligation does not apply in relation to products where information is not otherwise made available to the public.

Most private funds are not made available to retail investors; indeed, European and international marketing and securities law are generally clear that private funds may not be marketed to such investors except in certain clearly defined circumstances. These requirements are particularly stringent in certain countries, including the United States, and making information about specific products available to the public could have very serious consequences for the manager. Most

private equity and venture capital funds are only marketed to professional investors and, in practice, great care is taken to ensure that information about these products is not included in publicly available materials.

Invest Europe members believe that it would be inappropriate to make product-specific information available to the public generally, even with appropriate disclaimers, as this would seem contrary to the general policy objective of ensuring that only investors for whom a product is suitable are given information about that product. We also think it is not necessary because retail investors cannot typically invest in the products. The number of investors in private equity and venture capital funds are limited and investor disclosures, as required by Articles 8, 9 and 11, will ensure that they have the information that they need.

We therefore think that the Commission could helpfully clarify that product-specific website disclosures are only required where there is other information available about the product on a website. In this regard, we note that Article 33 of the draft RTS published last year by the ESAs said: "Financial market participants shall publish the information on their websites in accordance with Article 10(1) of Regulation (EU) 2019/2088 and this Chapter in a section titled 'Sustainability-related disclosures' **in the same part of the website as the other information relating to the financial product**, including marketing communications." By implication, if there is no other information about the financial product on the website, we would suggest that there would be no requirement to include it.